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Washington [illegible], D.C.

# INDEX



## CITATIONS





639785—62

# In the Supreme Court of the United States

OCTOBER TERM, 1961

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No. 793

MARK E. SCHLUDE AND MARZALIE SCHLUDE, PETITIONERS

*v.*

COMMISSIONER OF INTERNAL REVENUE

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*ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT*

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## BRIEF FOR THE RESPONDENT IN OPPOSITION

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### PRIOR OPINIONS

The findings of fact and opinion of the Tax Court (R. 203–221) are reported at 32 T.C. 1271. The first opinion of the Court of Appeals (Pet. 2a–16a) is reported at 283 F. 2d 234. The *per curiam* decision of this Court granting certiorari and remanding the case is reported at 367 U.S. 911. The order of this Court denying rehearing and amending the previous *per curiam* order is reported at 368 U.S. 873. The *per curiam* opinion of the Court of Appeals upon remand (Pet. 1a–2a) is reported at 296 F. 2d 721.

## JURISDICTION

The judgment of the Court of Appeals was entered on December 15, 1961. (Pet. 17a.) The petition for a writ of certiorari was filed on March 15, 1962. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

## QUESTIONS PRESENTED

1. Whether an accrual-basis taxpayer who contracts to provide a stated number of dancing lessons during a period extending beyond the close of the taxable year is required to accrue as income cash and negotiable notes received as an advance payment of the contract price.

2. Whether such a taxpayer is required to accrue as income future installments unconditionally due under the contract whether or not any lessons have been taken.

## STATEMENT

The taxpayers, husband and wife, formed a partnership in 1946 known as Arthur Murray Dance Studio (the "Studio"), for the purpose of conducting dance studios in territories authorized by various franchise agreements received from Arthur Murray, Inc., of New York City. The partnership operated studios in the States of Nebraska, Iowa and South Dakota, for the purpose of teaching private ballroom dancing to individual students. (R. 205–206; Pet. 3a.)

Basically, there were two kinds of contracts entered into between the partnership and students. Under one type, all of the down payment was made in cash at the time the contract was executed, with the balance

of the tuition or contract price to be paid in deferred installments. Under the other, a portion of the down payment was paid in cash at the time the contract was entered into, and the balance thereof was to be paid in installments; the remainder of the contract price was evidenced by a negotiable note taken from the student, which was payable in designated installments in accordance with its terms. (R. 206–207; Pet. 3a.)

All of the contracts provided (1) that the student would pay tuition for lessons in a certain amount, (2) that the student should not be relieved of his obligation to pay the tuition agreed upon in the contract, (3) that no refunds would be made, and (4) that the contract was noncancellable. The contracts provided for a specific number of hours of lessons ranging from 5 to 1,200. Some of the contracts were for lifetime courses under which, in addition to 1,200 specified hours, the student was entitled to 2 hours of lessons per month plus 2 parties a year for life. The contracts specified a period during which the lessons had to be taken but did not schedule specific dates for the lessons, the dates being arranged from time to time as lessons were given. Under most of the contracts in which lessons extended beyond the fiscal year in which the contract was made, the lessons were given in the next fiscal year. (R. 207–208; Pet. 3a–4a.)

Notes accompanying deferred payment contracts received by the Studio were negotiated with a local bank. At the time a student's note was negotiated

with the bank, the bank would deduct its interest charges, pay approximately 50 per cent of the balance of the note to the partnership, and set up a reserve account for the other 50 per cent of the note which the partnership could not use until after the note was paid in full by the student. After the note was paid, the balance in the reserve account was transferred to the partnership's general bank account. (R. 208; Pet. 4a.)

Cash payments received by the partnership directly from students, the amounts received by the partnership at the time notes were transferred to the bank, and the amounts received by the partnership when notes transferred to the bank were fully paid were either deposited or credited to a partnership general bank account without segregation from other partnership funds. (R. 208.)

Although the contracts stated that they were non-cancellable, the Studio frequently rewrote contracts to reduce the number of lessons and the total charge. Also, despite the fact that the contracts provided that no refund would be made, and despite the fact that the Studio discouraged refunds, occasionally a refund would be made on a canceled contract. (R. 208–209).

When the partnership was organized in 1946, a complete double entry bookkeeping system was installed for the partnership by a firm of certified public accountants, and an accrual system of accounting, with a fiscal year ending March 31, was employed. This accounting system was used continually and consistently from the time the partnership was formed.

Additionally, individual student record cards were maintained, listing all pertinent information such as name and address of student, type of contract, hours involved, total contract price, history of lessons taught, and payments made under the contract. (R. 209; Pet. 5a.)

The accounting method used by the partnership is shown in detail in the findings of the Tax Court. In substance, when a contract was entered into with a student, a "deferred income" account was credited with the total contract price. At the close of each fiscal year, the student record cards were analyzed and the number of hours of lessons taught was determined; this figure multiplied by the contract rate per hour, was regarded as the amount of income earned. This amount was then charged to "deferred income" and credited to "earned income." Earned income thus derived was reported as income on the partnership's tax return. Gain resulting from cancellation of a contract was also reported as taxable income in the year of cancellation. Detailed schedules reflecting the partnership's system of accounting during the years in question appear in the findings of fact of the Tax Court. (R. 209-213; Pet. 5a.)

The Commissioner ruled that the entire amount of the contract price represented gross income in the year in which the contract was entered into. (R. 214-215.) Accordingly, in his notices of deficiency he increased the ordinary net income of the partnership for the fiscal years ended March 31, 1952, 1953 and 1954, by

the amounts of the increases in the "deferred income" account in those years, *viz.*, $24,602.22 for 1952, $104,798.41 for 1953, and $12,797.97 for 1954. (R. 213; Pet. 5a–6a.) The Tax Court, three judges dissenting, sustained the Commissioner's determination. (R. 203–221.) The court of appeals, one judge dissenting, reversed the Tax Court. (Pet. 2a–16a.)

The Commissioner's petition for certiorari to review the court of appeals' decision was pending when this Court decided *American Automobile Assn. v. United States*, 367 U.S. 687. Thereafter, the Court granted certiorari, vacated the judgment, and remanded the case to the court of appeals for reconsideration in the light of that decision. 367 U.S. 911; 368 U.S. 873. Upon reconsideration, with full argument, the court of appeals vacated its prior judgment and affirmed the decision of the Tax Court, stating *per curiam* (296 F. 2d 721, 722):

> In light of * * * [*American Automobile Assn.*] we have carefully examined and considered petitioners' method of accrual accounting and are convinced that such method does not, for income tax purposes, clearly reflect income.

## ARGUMENT

1. In the year in which the dance-instruction contracts were made, petitioners received a substantial part of the contract price in cash. The decision below that the amounts thus received in cash must be included in income in the year of receipt and may not be "deferred" until subsequent years was, we submit,

required by this Court's decision in *American Automobile Assn. v. United States*, 367 U.S. 687.

In the *AAA* case, the Association, an accrual-basis taxpayer, was paid in advance membership dues for a 12-month membership period. Claiming that the dues were "earned" evenly over the period during which it was liable to perform services for the members, the Association, following accepted commercial accounting principles, accrued as income only one-twelfth of the dues for each month of membership falling within the taxable year. Rejecting the view that commercially-accepted accounting principles—in particular, the principle that income should not be accrued until "earned"—were determinative for income tax accounting, this Court upheld the Commissioner's rejection of the method of accounting used and required the dues to be included in income in the year received.

Petitioners seek to distinguish the *AAA* decision on the ground that the services to be performed by the Association for any single member were uncertain and contingent (*e.g.*, road service, contingent upon mechanical breakdowns) whereas the contracts here were for the performance of specific, identified, services (a definite number of dance lessons). It is true that the Court, both in *AAA* and in the predecessor decision in *Automobile Club of Michigan v. Commissioner*, 353 U.S. 180, emphasized the contingent nature of the services as a factor making the method of deferral used "artificial". Additionally, the Court distinguished *Beacon Publishing Co. v. Commissioner*, 218

F. 2d 697 (C.A. 10), and *Schuessler* v. *Commissioner*, 230 F. 2d 722 (C.A. 5), on the ground that in those cases the taxpayer was required "to furnish services at specified times in years subsequent to the tax year" while, in the case of the automobile clubs, "substantially all services are performed only upon a member's demand and the taxpayer's performance was not related to fixed dates after the tax year" (353 U.S. at 189, n. 20; 367 U.S. at 691, n. 4). Even assuming, however, that the *AAA* decision leaves open the validity of such a distinction, this case would fall on the *AAA*, rather than the *Beacon Publishing*, side of the line. While the contracts were nominally for a stated number of dance lessons to be given within stated time limits, the services were not to be performed, as in *Beacon* and *Schuessler* at "fixed dates" in the future but only as and when demanded by the customer. Nor is that a merely formal distinction, for petitioners' experience has been that a large proportion of the lessons contracted for are never taken, with the result that petitioners' actual performance under any individual contract is in fact uncertain and contingent. While the automobile clubs' per-month method of accrual was at least consistent with their actual group experience, petitioners' per-lesson method of accrual (based on the disproven assumption that all lessons contracted for will be taken) is contradicted by its own experience.

More importantly, however, we do not believe that the *AAA* decision can be limited, as petitioners would limit it, to cases in which the services to be performed are uncertain. The language upon which petitioner

relies for that distinction is found in the first part of the opinion, the burden of which was to show that the method of accounting used by the Association was subject to the same defect (uncertainty as to the time and nature of performance) as the method condemned in the earlier decision in *Automobile Club of Michigan*, making that decision controlling. As the *amicus curiae* brief seems to recognize, however (see *Amicus* Br. 11–12 and n. 6), the Court's opinion in *AAA* did not rest with reliance on the prior decision in *Michigan*. Pointing to "other considerations requiring our affirmance" independently of the controlling force of *Michigan* (367 U.S. at 694), the Court went on to demonstrate, from the history of the 1954 Code and its amendments dealing with the income-deferral problem, affirmative Congressional endorsement of the view long held by the Commissioner and the courts disallowing the deferral of income for tax purposes. From that demonstration, the Court concluded that it should follow the established administrative and judicial practice barring deferral and leave to Congress the carving out of appropriately limited exceptions, a course made particularly desirable by "the complications inherent in the problem and its seriousness to the general revenue" (367 U.S. at 697).[3] Whatever

[3] In addition to the extensive legislative activity in this field noted by the Court in the *AAA* opinion (367 U.S. at 694–697), Congress has since that decision added to the Code a specific provision authorizing—with specified limitations and safeguards—automobile clubs and certain other membership organizations to defer prepaid dues income for taxable years beginning after 1960. § 456 of the 1954 Code, added by § 1, Act of July 26, 1961, 75 Stat. 222. That step-by-step approach to a legislative solution (see also the specific provision added in 1958 to

may be said of the implications of the first part of the opinion, there is nothing in the rationale of the latter part by which to confine it to contingent-service contracts. That ground of the decision is equally applicable here and was properly found to be controlling by the lower court.[2]

2. Petitioners alternatively argue that, even if the cash payments must be accrued, the decision below is wrong at least insofar as it requires accrual not only of the portion of the contract price paid in cash but also of the portion due to be paid in installments in the following year.[3] Since the *AAA* case in fact in-

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permit deferral of subscription income, § 455) reflects Congress' caution in dealing with the problem of income deferral after the unexpected revenue loss occasioned by them forced Congress to repeal the original provisions of the 1954 Code generally authorizing the deferral of income and the creation of reserves for anticipated expenses (§§ 452 and 462, the history of which is recounted in the *AAA* opinion).

[2] The alternative holding of the *AAA* opinion also precludes any claim of conflict with the few prior decisions of the lower courts permitting income-deferral. Thus, while the *Beacon* and *Schuessler* cases, *supra*, were distinguished by the Court in *Michigan* and in the first part of the *AAA* opinion, neither their rationale nor their authority can survive this Court's analysis of the significance of the legislative history of income-deferral. Whether or not they were technically "overruled," those decisions are no longer of sufficient viability to establish a conflict. As we have previously noted, those cases are in any event distinguishable on their facts.

[3] In many instances, petitioners received negotiable notes for the unpaid part of the contract price. Petitioners raise no separate question as to the treatment of the notes and impliedly acknowledge that for accrual purposes they stand on the same footing as the amounts paid in cash. Cf. *Commissioner* v. *Hansen*, 360 U.S. 446; *General Gas Corp.* v. *Commissioner*, 293 F. 2d 35 (C.A. 5), certiorari denied, 369 U.S. 816; *Shapiro* v. *Commissioner*, 295 F. 2d 306 (C.A. 9), certiorari denied, 369

volved only actual cash receipts, the Court cannot be said to have passed on this precise question in that case. Nevertheless, the decision below is fully supported by the implications of that decision, and the question is not in any event of sufficient importance to warrant review by this Court in the absence of a conflict.

In urging the importance of the question, both petitioners and the *amicus* brief assume that the decision below requires immediate accrual of the total contract price upon the making of any and all kinds of executory contracts (Pet. 12-13; Amicus Br. 14-19). Were that the implication of the decision, we might well agree that the question was of broad importance and warranted review by this Court. In fact, however, the decision below is confined to the atypical payment provisions of these particular contracts. It does not at all imply, and the government has not contended, that an accrual basis taxpayer must accrue income whenever he signs a contract to perform services.

For accrual accounting purposes, the crucial event is the coming into being of a fixed right to receive payment (or, on the deduction side, a fixed obligation to pay). In most business contracts, the promise to pay and the promise to perform are dependent covenants, and no duty to pay (and hence no right to receive payment) comes into being until after performance. The right to receive payment being conditioned

U.S. 829; *Morgan* v. *Commissioner*, 277 F. 2d 152 (C.A. 9); *Wiley* v. *Commissioner*, 266 F. 2d 48 (C.A. 6), certiorari denied, 361 U.S. 831. The discussion in text is limited to the amounts payable in installments for which no notes were given.

upon performance, there is no unconditional right to payment until performance is completed and hence no basis for accrual of the contract price until then.

In the contracts in this case, however, the promise to pay and the promise to perform are not dependent covenants. There is rather an unqualified promise to pay that is neither conditioned upon performance nor related in time to the dates of performance. The contracts call, in effect, for prepayment of the total contract price but permit deferred installment payments of the balance which the student is unable to pay immediately. Neither the amounts nor the due dates of the installments have any relationship to the number of lessons actually given or expected to be given by those dates, and the payments are unconditionally due even if none of the lessons contracted for have yet been given. While petitioners are independently bound by their undertaking to furnish lessons (and an anticipatory breach of that duty might relieve the student of his duty to complete payment), the furnishing of any particular number of lessons is not a contractual precondition to payment.

In such a case, the conclusion of the court below that the unconditional right to payment must be accrued when it comes into being (*i.e.*, upon the signing of the contract) seems a logical implication of the *AAA* decision. While that case in fact involved only cash receipts, under accrual accounting principles an actual receipt and an unconditional right to receive are for all purposes equivalent. The significance of

the *AAA* decision is rather that it rejected the attempt to inject into tax accounting the principle of commercial accounting that income should be accrued when *earned* and reaffirmed the established principle[4] that it is the fixed right to receive or the fixed obligation to pay that is controlling for tax purposes. With the right to payment in this case being fixed and unconditional, and with the date of actual payment being irrelevant for purposes of accrual accounting, the only ground upon which accrual of the income could be postponed is that income should not be accrued until "earned," and it was precisely that principle of accounting that was rejected in the *AAA* case.

Whatever the merits of the decision below as to the contractual payment rights, however, the issue does not at the present time merit further review by this Court. The *AAA* case was decided only last Term and there has as yet been little development of its implications in the lower courts. The decision below turns on the seemingly unusual features of the contracts involved, and it has not been demonstrated that the question, thus limited, is of widespread importance. There is no conflict and the decision below is one of first impression in the courts of appeals. Even should the question prove to be of greater importance than it has yet been shown to be, it can profitably be left to further development in the lower courts before further consideration by this Court.

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[4] See, *e.g.*, *Security Mills Co.* v. *Commissioner*, 321 U.S. 281, 286-287; *Spring City Foundry Co.* v. *Commissioner*, 292 U.S. 182; *Commissioner* v. *Hansen*, 360 U.S. 446, 464.

## CONCLUSION

For the reasons stated, the petition for certiorari should be denied.

Respectfully submitted.

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